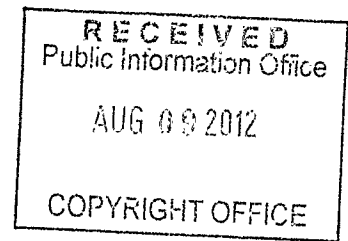


Before the  
UNITED STATES COPYRIGHT ROYALTY JUDGES  
Washington, D.C.

In the Matter of:

Determination of Rates and Terms for  
Preexisting Subscription Services and  
Satellite Digital Audio Radio Services

Docket No. 2011-1  
CRB PSS/Satellite II



AMENDED REBUTTAL TESTIMONY OF

**JANUSZ ORDOVER**

Professor of Economics and former Director of the  
Masters in Economics Program at New York University

**Public Version**

Witness for SoundExchange, Inc.

## I. Introduction and Assignment

1. My name is Janusz A. Ordovery. During the direct phase of this proceeding, I submitted written testimony,<sup>1</sup> provided testimony at deposition,<sup>2</sup> and testified at a hearing held before the Copyright Royalty Judges.<sup>3</sup>

2. I have been asked by counsel for SoundExchange to review the written direct testimony prepared by Dr. Roger Noll<sup>4</sup> on behalf of Sirius XM, as well as Dr. Noll's deposition<sup>5</sup> and hearing testimony provided during the direct phase of this proceeding.<sup>6</sup> My examination of Dr. Noll's testimony assesses whether the benchmark rates put forward by Dr. Noll represent economically reasonable estimates of the rates that likely would obtain through voluntary negotiations between Sirius XM and individual record labels, *i.e.*, through negotiations occurring outside the regulatory framework that governs the determination of rates to be paid by Sirius XM for access to sound recording rights.

## II. Summary of Conclusions

3. In developing the conclusions that are summarized below and discussed in greater detail in the main body of this report, I relied on my experience in assessing pricing issues generally, as well as pricing of access to content across

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<sup>1</sup> Third Corrected and Amended Written Direct Testimony of Janusz Ordovery, June 13, 2012 (SX Trial Ex. 74).

<sup>2</sup> Deposition of Janusz Ordovery, March 19, 2012.

<sup>3</sup> Direct Hearing Transcript, Vols. 8-9, June 14-15, 2012.

<sup>4</sup> Revised Amended Written Direct Testimony of Roger G. Noll, May 17, 2012 ("Noll Report") (SXM Dir. Trial Ex. 1).

<sup>5</sup> Deposition of Roger Noll, March 8, 2012 ("Noll Deposition").

<sup>6</sup> Direct Hearing Transcript, Vols. 1-2, June 5-6, 2012 ("Noll Hearing Testimony").

numerous industries (such as music, motion pictures, software, and cable television), the relevant economic literature, and my knowledge of the music industry. In addition, I reviewed the written and deposition testimony of Professors Noll and Hauser, the deposition testimony of Messrs. Frear and Gertz, the transcripts of the direct hearing, the written rebuttal testimony of Mark Eisenberg, the written rebuttal testimony of Professor Itamar Simonson, the written rebuttal testimony of David Pearlman, and various materials produced by Sirius XM.

4. My overarching conclusion is that neither of the benchmark approaches put forward by Dr. Noll represents an economically reasonable basis on which to determine the licensing rates Sirius XM should pay for access to sound recording performance rights for its satellite radio service.

5. Dr. Noll's first, and preferred, approach builds from a set of direct licenses negotiated between Sirius XM and independent record labels that is wholly unsuitable as a benchmark in this proceeding. The most glaring deficiency of Dr. Noll's first approach is his assertion that licensing rates rejected by the overwhelming majority of record labels with whom Sirius XM negotiated should nevertheless be applied to the recording industry at-large. In defense, Dr. Noll claims that most record labels declined Sirius XM's overtures because the procedures governing this proceeding tilt in favor of the record companies, *i.e.*, they reasonably can expect the Judges to set rates at above-competitive levels. I find nothing in the Judges' prior analyses and opinions to support such a view, and indeed, the presence of the fourth statutory factor directly contradicts this view insofar as its implementation would depress rates to below-competitive levels to account for Sirius XM's supposed financial fragility. Finally, the direct license agreements are anomalous in at least a couple of respects, namely that they involve labels with minuscule exposure on Sirius XM, and that many contain provisions (explicit and otherwise) that offer inducements for labels to accept lower rates.

6. Dr. Noll's second approach flows from the premise that non-interactive streaming services are highly comparable to the music content distributed by Sirius XM, and therefore can be used as a benchmark without the need for any adjustments. This assumption is patently flawed. The substantial difference in price between Sirius XM's (hypothetical music-only) service and non-interactive services like Pandora and Last.fm, coupled with Sirius XM's substantially larger subscriber base, suggests that a number of adjustments would be necessary to use the non-interactive services as a benchmark for Sirius XM. Moreover, Sirius XM executives have acknowledged that although Sirius XM competes with non-interactive services today, that competition will not have a material impact on Sirius XM's performance unless and until automobile manufacturers elect to integrate the required functionality into their vehicles.<sup>7</sup>

7. In terms of implementation, Dr. Noll's second approach suffers from a number of serious flaws. First, his initial benchmark rates are obtained from four agreements with a single service – a sample size so small as to cast immediate doubt on its utility. Second, the sample size issue is compounded when Dr. Noll attempts to account for the per-play mechanism in his chosen agreements, insofar as he relies on a single month of usage data from a single service. Besides the inherent difficulty in drawing inferences from a single data point, the figure adopted by Dr. Noll varies substantially from other estimates that can be derived using information from Pandora and Sirius XM. And finally, all of the methods used by Dr. Noll to gauge the retail price of a hypothetical music-only satellite radio service are fundamentally flawed and generate estimates that substantially undervalue Sirius XM's access to music content.

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<sup>7</sup> SIRI - Sirius Satellite Radio at Morgan Stanley Technology, Media & Telecom Conference," Thomson Reuters StreetEvents, February 28, 2012, p. 11 (Sirius XM CFO David Frear stating, in the context of competition between Sirius XM and internet radio in the car, that "if there is going to be a disruptive technology impact to our business, I think we would have seen it already") (SX Ex. 223-RP).

7a. Pursuant to 37 C.F.R. § 351.4(c), I am amending this testimony based on new information received during the discovery process. Specifically, I have added: (1) information about the number of fully executed direct licenses in footnote 8; (2) a new sentence in paragraph 62 and new footnote 46a, both discussing Dr. Noll's calculation of Pandora's monthly plays per paying subscriber; (3) new footnote 51a, discussing Dr. Noll's assessment of plays per subscriber on non-interactive streaming services; and (4) three new sentences in paragraph 68 and new footnotes 54a and 54b, discussing Sirius XM's pricing of its internet service and its satellite radio service. These amendments are based on documents produced by Sirius XM or depositions of Sirius XM witnesses conducted in discovery. I have not otherwise amended or corrected this testimony.

### **III. Dr. Noll's First Benchmark: Sirius XM Direct Licenses**

#### **A. Introduction**

8. Dr. Noll's first approach relies on a set of license agreements negotiated directly between Sirius XM and independent record labels. As of the submission date of Dr. Noll's initial direct written testimony, November 29, 2011, Sirius XM had successfully negotiated licenses with 62 independent labels.<sup>8</sup> Collectively, the catalogs of these labels span a range of musical genres including Folk, Electronic, Pop, R&B, Punk, Alternative, Rock, Christian, Jazz, Gospel, Children's, and Hip-Hop.<sup>9</sup> Despite the range of genres represented, the catalogs

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<sup>8</sup> Noll Report at Table 1. Based on the most recent information available in the case record, the total number of executed direct licenses was 85. None of my conclusions about the usefulness of the direct licenses as a benchmark are materially affected by this increase in the number of signed licenses. Because Dr. Noll's conclusions are based solely on the 62 direct licenses executed at the time of the initial submission of his testimony, in the remainder of this testimony I similarly focus on that set of licenses. As discussed below, Sirius XM attempted to negotiate direct deals with nearly 600 record labels.

<sup>9</sup> Id.

of these 62 labels, taken together, historically have accounted for a *de minimis* portion of total airplay across Sirius XM's music channels – roughly between

[ ]<sup>10</sup>.

9. In Dr. Noll's opinion, Sirius XM's direct licenses with independent record labels represent "the most appropriate benchmarks for setting a statutory rate for SDARS."<sup>11</sup> He advances several arguments in support for this view:<sup>12</sup>

- a. The direct licenses include sound recording performance rights, which are the very same rights at issue in this proceeding;
- b. The sellers, independent record labels, are similar to the sellers for which rates will be determined in this proceeding;
- c. The buyer, Sirius XM, is the same buyer for which rates will be determined in this proceeding; and
- d. Rates directly negotiated between Sirius XM and independent record labels reflect competition among record labels to divert demand from other record labels, *i.e.*, to increase the extent to which their catalogs are played on Sirius XM.

10. Dr. Noll's arguments are not compelling. For reasons discussed below, these agreements fail to offer useful empirical evidence of the range of rates likely to arise through voluntary negotiations for sound recording performance rights between Sirius XM and record labels in a hypothetical marketplace free of the compulsory license regime.

#### **B. Dr. Noll's Reliance on Sirius XM Direct Licenses Is Deeply Flawed**

*Dr. Noll fails to address adequately the fact that all but a small fraction of record labels approached by Sirius XM elected not to sign direct deals at the rates adopted by Dr. Noll as his benchmark.*

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<sup>10</sup> See Written Rebuttal Testimony of Mark Eisenberg, at ¶ 17-18 ("Eisenberg Report").

<sup>11</sup> Noll Report at p. 10.

<sup>12</sup> Noll Report at pp. 32-33.

11. The 62 direct deals comprise a decidedly biased sample on which to predict likely marketplace outcomes more generally, for the simple reason that the number of labels that entered into direct licenses with Sirius XM is dwarfed by the number of labels that declined to grant a license to Sirius XM at the rates offered by Sirius XM. More specifically, the 62 labels with which Sirius XM reached agreement are a relatively small sub-set of the nearly 600 labels that Sirius XM approached in the first instance.

12. Given that most record labels approached by Sirius XM did not sign direct licenses, Dr. Noll's reliance on the 62 direct deals is highly suspect. In any case, it is incumbent upon Dr. Noll to explain why a range of rates accepted by a relatively small fraction of the labels contacted by Sirius XM properly can serve as a benchmark for a statutory rate that will apply to the vast majority of record labels, including hundreds that either have not responded to, or have explicitly rejected, Sirius XM's overtures.

13. The only defense offered by Dr. Noll is that SoundExchange serves as a vehicle through which record labels collusively agree to refrain from signing direct licenses with Sirius XM and instead pursue the determination of a rate through the CRB. 6/6/12 Tr. 314:20-315:6 (Noll) ("I believe that there were a lot of labels that believe they'd be better off acting collectively and, in particular, certainly the majors believed that."); *see also* 6/6/12 Tr. 317:21-318:4. That uniform rate, according to Dr. Noll, is preferred by record labels, for two reasons. First, a uniform rate supposedly eliminates competition among record labels for greater airplay, *i.e.*, demand diversion, that otherwise would occur and thereby drive down licensing rates for sound recording performance rights.<sup>13</sup> And second, the very process by which the CRB determines a rate is purportedly stacked in favor of SoundExchange, for reasons principally concerning the timing of

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<sup>13</sup> Noll Report at 41-42.

production that creates information asymmetries that favor SoundExchange in the rate-setting process. 6/6/12 Tr. 320:16-322:7 (Noll).

14. Taken together, Dr. Noll's discussion boils down to the view that record labels reasonably expect the rate determined through the CRB process to be higher than the rate(s) that would obtain *via* direct negotiations with Sirius XM. Or stated differently, Dr. Noll's contention is that most record labels expect the CRB process to yield a rate above what he would regard as at a competitive level. Dr. Noll's opinion is unfounded.

15. As to Dr. Noll's claim that a uniform regulated rate eliminates demand diversion with respect to airplay on Sirius XM, there are two responses. First, to the extent the CRB sets the uniform rate using as its benchmark the rates from a workably competitive and unregulated market, the benchmark market rates should reflect any effects of demand diversion in the services operating in that market, and therefore the statutory rate derived from that benchmark market likewise should capture the effects of demand diversion. In other words, a statutory rate that is set based on an appropriate benchmark, properly adjusted to account for any relevant differences between the benchmark and target markets, will reflect all market influences including demand diversion.<sup>14</sup> Second, if it were the case that the statutory rate set by this Court did not reflect the effects of demand diversion, one might expect some number of record labels to undersell the statutory rate in an effort to gain a greater proportion of airplay on Sirius XM. The mere existence of a uniform statutory rate does not prevent price competition among record labels if the statutory rate is set at an above-market price.

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<sup>14</sup> Previously, the Court has used the market for subscription interactive music streaming services as its benchmark. Although interactive services allow consumers to request particular sound recordings on demand, so that the royalty rate being charged by the record label will not influence the listening choice of the consumer, it is also true that such services often recommend music to their subscribers and "push" a playlist when the subscriber is not actively selecting the music to be streamed. Consequently, it is reasonable to expect that the royalty rates negotiated by record labels with subscription interactive services take into account demand diversion effects.



16. As to Dr. Noll's argument that the regulatory process is stacked in favor of SoundExchange, there is no good reason to believe that proper application of the four statutory criteria that govern this proceeding likely will result in a rate in excess of competitive levels. If anything, the opposite might be true. As I explained in my written direct testimony, the first three statutory criteria call for the consideration of factors that reasonably would shape negotiations in an unfettered marketplace setting. The fourth factor, however, considers whether the rate might materially disrupt the ongoing viability of Sirius XM's business operations. Should the Court determine that application of this factor is warranted, it cannot elevate the statutory rate to above-competitive levels but rather can only lower it.

17. Dr. Noll does not acknowledge that the fourth statutory factor might inure to the disadvantage of the record labels. Instead, he highlights the rules that govern discovery, and in particular the fact that written direct testimony is submitted prior to the production of documents and other relevant information via discovery.<sup>15</sup> While Dr. Noll is correct that SoundExchange's witnesses have the exclusive ability to review and analyze certain documents and data in the custody of SoundExchange or its members, and to incorporate the results of such analyses into their written direct testimony, it is indisputable that a similar advantage is enjoyed by Sirius XM's witnesses, who for their written direct testimony have exclusive access to Sirius XM documents and data.

18. Dr. Noll acknowledges that the discovery rules cut both ways, but asserts that on balance they benefit SoundExchange due to its supposed greater reservoir of pertinent evidence. 6/6/12 Tr. 318:20-320:9 (Noll). This view is indefensible – one need look no further than the fact that in preparing my written direct testimony I did not have access to any information pertaining to the very centerpiece of Dr. Noll's analysis – Sirius XM's direct licenses with independent

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<sup>15</sup> Noll Deposition Tr. 103:12-105:13.

record labels. But more importantly, whatever claimed advantage SoundExchange might have initially as a result of information asymmetries is surely eliminated through the discovery process and the ability of the witnesses to amend their written direct testimony based on discovery. In fact, Dr. Noll agrees that he received over 2,000 digital rights agreements in discovery, that he amended his written direct testimony based on that discovery, and that “[i]n fact, most of the discussion in my testimony about deals is based on discovery.” 6/6/12 Tr. 330: 2-18 (Noll). In addition, information obtained through the discovery process may be incorporated in rebuttal reports and brought to the attention of the Judges in that fashion. If there is any information imbalance, it is quite temporary and certainly should not interfere with the ability of the Judges to set appropriate rates based on the application of the statutory standard.<sup>16</sup>

19. Related to his claim that the operative regulatory framework in this proceeding tilts in favor of SoundExchange, Dr. Noll advances the more general contention that the regulatory process is “inherently biased in favor of the regulated entity.”<sup>17</sup> It is simply not correct, in my view, that as a general principal regulated entities benefit from an inherent bias in their favor. Railroads, for example, were heavily regulated until a series of legislative enactments largely

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<sup>16</sup> Dr. Noll also takes issue with the fact that SoundExchange can designate certain licensing agreements as non-precedential, *i.e.*, they cannot be used in proceedings before the CRB. There is a certain irony to that argument, because when Sirius XM entered into an agreement with SoundExchange to establish the rates for the Sirius XM webcasting service, Sirius XM requested and received SoundExchange’s agreement that those webcasting rates could not be used as precedent in this proceeding (although they could be used as precedent in the webcasting proceeding). In any event, given my understanding that Dr. Noll had access to more than 2,000 digital music licensing deals, I find it hard to believe that the exclusion of a handful of deals could materially handicap his efforts in deriving the relevant rate in this proceeding. That is particularly so because the only non-precedential deal of any real relevance is that which set the rates for Pandora and certain other webcasting services. As I explain below, we know from public sources that Pandora pays approximately 50% of its revenues in sound recording royalties, and this non-precedential agreement would not have supported Dr. Noll’s benchmark analysis.

<sup>17</sup> Noll Deposition Tr. 83:16-84:4.

deregulated the industry in the late 1970s and early 1980s. Railroads have experienced far greater economic success in the deregulated market economy than they did under the prior regulatory scheme.

20. Dr. Noll's central thesis that the great majority of independent record labels declined the offer of a direct license because they expected above-market rates from this Court does not find support in the relevant statutes or regulations. That most record labels rejected the direct license is far more likely to reflect a view that Sirius XM offered below-market royalty rates.

*The direct licenses that form the basis of Dr. Noll's benchmark are heavily skewed towards small independent labels that represent artists with limited to nonexistent mainstream appeal.*

21. Despite the fact that the overwhelming majority of labels offered a direct license declined to accept, Dr. Noll contends that the relatively few independent record labels that executed direct licenses are reasonably representative of the large majority that did not. The collection of 62 direct licenses that underlies Dr. Noll's preferred benchmark, however, involves record labels that are uniformly small and, for the most part, feature artists with no more than a niche or fringe following. Many labels with direct licenses feature artists whose works fall outside the mainstream, including genres such as Christian, blue grass, punk, goth, and children's music.<sup>18</sup>

22. Prior to the direct licensing initiative, no single one of the 62 labels that signed a direct deal represented more than [ ] of song plays on Sirius XM, and collectively, the 62 labels accounted for no more than around 2% of song plays on Sirius XM.<sup>19</sup> As a threshold matter, a benchmark based on such a tiny sliver of the marketplace is highly problematic.

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<sup>18</sup> Noll Report at Table 1.

<sup>19</sup> Eisenberg Report at ¶ 17.

23. Dr. Noll attempts to defend the relevance of his benchmark, notwithstanding the consistently miniscule share of the pertinent independent labels, by claiming that their repertoires, when viewed as a single collection, closely mimic the scope of song catalogs offered by the major record labels and that are highly important to the successful operation of a mainstream music service.<sup>20</sup> Dr. Noll's argument is flawed in two respects.

24. First, even if one accepts his assertion that the collective song catalogs of the relevant independent labels resemble substantially the catalog of a major label in terms of breadth across genres and popularity, the fact remains that Sirius XM did not negotiate the sound recording performance rights for all of these catalogs with one label in a single transaction. Rather, it negotiated with each small label independently. A larger label with a broad catalog of popular recordings across a number of genres likely will negotiate a higher rate than each small label with the same collective catalog could negotiate. The bigger the label and the larger its catalog of popular recordings, the more important it is for Sirius XM to avoid operating at a competitive disadvantage due to the absence of that entire catalog.

25. Sirius XM recognized this fact in its negotiations by offering higher rates to labels with a larger share of plays on Sirius XM. As explained by Ronald Gertz, candidate labels were assigned to one of three royalty rate buckets - 5%, 6%, or 7% - as a function of their share of plays. 6/7/12 Tr. 842:15-19 (Gertz).<sup>21</sup> The nature of Sirius XM's tiered royalty structure is consistent with the presence of a positive relationship between a label's importance (as measured by share of plays) and the label's negotiating position *vis-à-vis* Sirius XM. Sirius XM's CFO, Mr. Frear, confirmed at trial that Sirius XM generally was willing to offer higher

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<sup>20</sup> Noll Report at pp. 40-43; *see also* 6/6/12 Tr. 350:9-351:22.

<sup>21</sup> Sirius XM was willing to increase the royalty rate to 7% when it was requested by the labels, but the initial offers appear to have been driven heavily by the market share analysis conducted for Sirius XM. *See* Eisenberg Report at ¶¶ 11, 13.

rates for bigger and more popular catalogs. 6/7/12 Tr. 711:12-712:18 (Frear). As such, it strains credulity to suggest that a small label with a tiny market share can be considered representative of a much larger label by the simple trick of pretending that it is part of a collective.

26. Even if one were to accept Dr. Noll's invitation to think of the labels that signed direct licenses as a collective and ignore the reality that they are not, Dr. Noll fails to demonstrate that the benchmark independent labels represent current artists with mainstream consumer appeal. As observed by MRI representative Ron Gertz, "SiriusXM is very hits driven, and they want to have the most successful service they can, so they're going to use what's popular." 6/7/12 Tr. 836:17-22 (Gertz).

27. Yet in the section of Dr. Noll's written direct testimony headed "Types and Quality of Recordings", there appears to be no quantitative assessment of the popularity of the sound recordings owned by these labels and the extent to which they hold the rights to current hits.<sup>22</sup> Dr. Noll did not make any effort as part of his written direct testimony to analyze whether the labels that signed direct licenses had sound recordings that currently appear on Billboard charts, 6/6/12 Tr. 374:9-14 (Noll). And the specific examples of representative labels and artists that he cites are: (1) a label specializing in Broadway recordings; (2) three "former hit singles" that are actually re-recordings of the original hit versions of the songs he has cited; and (3) George Carlin, who, although one of the most popular comedians of all time, can hardly be considered representative of the popular music that has broad appeal among Sirius XM's subscriber base.<sup>23</sup>

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<sup>22</sup> Dr. Noll agrees that "quality," in this context, refers to the popularity of sound recordings among consumers. 6/6/12 Tr. 353:1-354:22 (Noll).

<sup>23</sup> Noll Report at 44-45.

28. Outside of his written testimony, when Dr. Noll has provided examples of artists and labels that support his reliance on the direct licenses, he has chosen artists that appear to have not signed direct licenses. For example, at his deposition, Dr. Noll referenced the band The Civil Wars as an example of a hit artist signed to a small independent label.<sup>24</sup> However, I have seen no evidence that the label representing The Civil Wars, Sensibility Music, has signed a direct deal with Sirius XM. Similarly, during his oral testimony, he referred to Lady Antebellum, again as an example of an artist that owns its own label. 6/5/12 Tr. 343:12-17 (Noll). That band, however, appears to be signed to EMI.<sup>25</sup>

29. Dr. Noll also adopts a rather specific definition of a hit song – in his view a “hit” is defined within its genre, and not with respect to overall consumer demand (popularity). 6/6/12 Tr. 367:13-18 (Noll). Of course, a popular song within a genre that enjoys limited consumer interest is, almost by definition, of limited popularity with the broader listening public. In short, Dr. Noll fails to demonstrate that the directly licensed independent labels represent artists whose music, at present, enjoys a broad-based consumer following. As a result, even if one accepts (incorrectly) as relevant the scope of the collective catalogs of the directly licensed independents *vis-à-vis* the catalog of a major label, Dr. Noll does not establish the similarity that he asserts is present.

*Sirius XM's direct licenses with independent record labels are a poor benchmark because they were negotiated in the shadow of regulation and do not reflect unfettered competitive market outcomes.*

30. The direct licenses used by Dr. Noll to construct his benchmark were negotiated in the shadow of regulation, which lessens their utility as reasonable marketplace benchmarks. Rates negotiated in the shadow of regulation present a

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<sup>24</sup> Noll Deposition Tr. 135:20-137:11.

<sup>25</sup> See All Music Guide – Lady Antebellum, <http://www.allmusic.com/artist/lady-antebellum-mn0000946769>.

problem when one attempts to use them as a benchmark to derive a market rate, because in the regulated market the seller is compelled to sell. Unlike an unregulated market, where the seller may simply decline to enter into a transaction if the price offered is deemed by the seller to be insufficient, in the regulated market the seller must sell either at a price agreed to through negotiation, or at the price set by regulation. That being so, negotiations in a regulated setting reflect not only market considerations, but also the parties' predictions about what rate the Court would set if negotiations failed.<sup>26</sup>

31. That is not to say that rates negotiated against a regulatory backdrop can never offer probative corroboration of benchmark rates based on unfettered marketplace outcomes. In the *Webcasting III* proceeding, I concluded that rates negotiated between SoundExchange and the National Association of Broadcasters (NAB) provided useful corroboration of benchmark rates derived from observed outcomes in digital music channels not subject to regulatory oversight, in particular interactive streaming services.<sup>27</sup> The circumstances present there, however, are not present here.

32. First, central to my conclusion in *Webcasting III* was the fact that both SoundExchange and the NAB had substantial familiarity with the CRB process. The NAB had participated directly and extensively in the *Webcasting II* proceedings, and therefore could reasonably predict the rates the Court would set if called upon to do so.

33. Second, the NAB is an organization that represents major broadcasting companies, and presumably had the resources to investigate any changes in the market that might have affected the rates set by the Court in *Webcasting III*.

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<sup>26</sup> Dr. Noll agrees with this proposition. See 6/6/12 Tr. 335:16-21; 336:21-337:6 (Noll).

<sup>27</sup> Written Rebuttal Testimony of Janusz Ordovery, June 2010, Docket No. 2009-1/CRB *Webcasting III*, at ¶¶ 32-42.

34. Third, as I pointed out in my *Webcasting III* testimony, the NAB member companies were not required to buy sound recordings at a price negotiated with SoundExchange. That is, unlike the sellers in this market, the buyers were not compelled by statute to buy, and as large companies whose revenues were derived primarily from over-the-air broadcasting rather than webcasting, they had the option to simply exit the market if the rates offered by SoundExchange (or set by the Court) exceeded reasonable market rates. Under those circumstances, the rates voluntarily negotiated by the NAB companies would not likely exceed marketplace rates.

35. Here, none of these factors are present. None of the independent labels with direct licenses participated in the first SDARS proceeding, and I am aware of no evidence that they have a solid grasp of the applicable regulatory framework. Indeed, it is my understanding that some of these independent labels lack any familiarity with SoundExchange and the services it provides on behalf of its record label members.<sup>28</sup> Moreover, I am aware of no evidence in the record that the independent labels with direct deals understood the methodological steps employed by the Judges in the first SDARS proceeding, in particular that the rate schedule set by the Judges incorporated a material downward adjustment – *via* application of the fourth statutory factor – to account for their view that satellite radio’s forward looking viability otherwise would be threatened substantially.<sup>29</sup> The independent labels with direct deals, lacking an understanding of the key role

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<sup>28</sup> According to the testimony of Mark Eisenberg, as many as 20 of the independent labels that executed direct licenses had not previously registered with SoundExchange and had not previously received royalties for the use of their sound recordings by Sirius XM. *See* Eisenberg Report at ¶ 57. Certainly, this suggests that many of the labels that signed direct licenses had very little if any knowledge of the regulatory environment and little incentive to learn about it.

<sup>29</sup> *Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services*, Final Rule and Order, 73 Fed. Reg. 4080, 4097-98 (Jan. 24, 2008) (concluding that “there are two circumstances faced by the SDARS that merit the adoption of a rate below the upper boundary of the zone of reasonable market rates we have identified hereinbefore (i.e., 13%).



the fourth factor played in the last proceeding, reasonably might view the current statutory rate as a highly reliable predictor of the rates the Court will set in this proceeding, and therefore be willing to accept rates at roughly equivalent levels when offered directly by Sirius XM.<sup>30</sup>

36. In addition, the labels that signed direct deals generally are quite small and presumably sufficiently resource-constrained to preclude any in-depth examination or analysis of the facts and circumstances that might lead the Court to increase the statutory rate. Moreover, their incentives to investigate thoroughly the Court's analytical history are muted by the modest dollar amount of royalties at stake for any one of them.

37. In these circumstances, the fact that the direct licenses between independent labels and Sirius XM were negotiated in the shadow of regulation renders these agreements unsuitable as probative evidence of rates that would obtain in an unfettered marketplace setting. And in any circumstances, it would be dangerous to accept such rates as the primary benchmark, as opposed to their serving a supplementary role as evidence that corroborates an appropriate benchmark less influenced by the direct effects of regulation.

*Sirius XM's direct licenses are a poor benchmark because the incentives of the independent labels that signed such deals differ markedly from the incentives of larger record companies.*

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<sup>30</sup> I understand that representatives for Sirius XM communicated to at least some of the record labels that the statutory rate would [REDACTED]. See, e.g., SXM\_CRB\_DIR\_00055365 (email from MRI to label representatives explaining that "[REDACTED]

[REDACTED]); see also Eisenberg Report at

¶ 55. I also understand that SoundExchange and other recording industry organizations issued press releases indicating that these organizations believed a far more substantial rate increase was appropriate. I do not know whether these record labels saw the recording industry press releases. Hence, I cannot exclude the possibility that their only source of information with respect to the future statutory rate was Sirius XM and its representatives.

38. A further serious shortcoming of Dr. Noll's direct licensing benchmark relates to the economic incentives of the labels that signed such deals, and more importantly, how those incentives differ from the economic interests of larger labels that declined to reach agreement directly with Sirius XM. Dr. Noll acknowledges the presence of such differences, 6/6/12 Tr. 357:13-358:11 (Noll), but fails to address their significance *vis-à-vis* the relevance of his proposed benchmark. In short, the direct licenses fail to represent a reliable benchmark because the economic incentives of the direct licensees are substantially different from those that would shape the negotiation strategies of larger record labels.

39. Dr. Noll identifies three factors that led certain independent labels to sign direct licenses with Sirius XM. The first factor relates to their expectations concerning the schedule of statutory rates the Judges ultimately will establish.<sup>31</sup> As noted earlier, those expectations do not benefit from a solid understanding of the operative regulatory framework, or in at least some cases even from awareness of the role served by SoundExchange. As a result, the directly negotiated rates fail to provide probative evidence of rates that would obtain through unfettered marketplace interactions.

40. The second factor discussed by Dr. Noll centers around a label's interest not in the royalty rate itself, but rather in the royalty revenues it expects to receive, *i.e.*, the product of the royalty rate and the volume of plays associated with the label's catalog. Of course, each and every label, large or small, seeks to maximize expected royalty revenue,<sup>32</sup> but the relative importance of the two components in how they approach rate negotiation that generate total royalty revenue depends on a label's size (*i.e.*, importance to Sirius XM, as reflected in volume of plays). More specifically, the smaller is a label's volume of airplay on

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<sup>31</sup> Noll Deposition Tr. 116:13-19.

<sup>32</sup> Here, I assume that royalty revenue flows entirely, or at least nearly so, to the bottom line, *i.e.*, profits.

Sirius XM, the less importance it should place on the royalty rate relative to airplay volume when considering the economic consequences or a lower rate versus additional volume of plays. 6/6/12 Tr. 364:3-12 (Noll); *see also* 6/6/12 Tr. 360:8-16 (Noll). This is so because a small label has an incentive to accept a lower rate if, as a result, the label can expect an even modest stimulation in airplay volume of its catalog (on a weekly basis, say).<sup>33</sup> For larger labels, however, the calculus looks quite different insofar as a far more substantial increase in airplay volume is required to counterbalance the downward effect of the same reduction in a royalty rate on royalty revenues.

41. Dr. Noll recognizes that, in his words, “this is an industry with a very small number of dominant firms and a very large number of tiny fringe firms, and the incentives operating upon the fringe firms are very different than the incentives operating upon the dominant firms.” 6/6/12 Tr. 357:14-358:11 (Noll). He agrees that a small independent label with minimal airplay will place less emphasis on the royalty rate, 6/6/12 Tr. 360:9-16 (Noll), while “[t]he people that really care about the rate are the ones who are played a lot, and that’s mainly the majors. They’re the ones who care most about the rate.” 6/6/12 Tr. 364:3-12 (Noll).

42. In this regard, Dr. Noll is correct, because a small indie whose sound recordings are rarely played might reasonably think that it could double, triple or quadruple its plays on Sirius XM, given that even this magnitude of increased plays would require only a minor change in Sirius XM’s overall playlists. Such

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<sup>33</sup> If a label’s profits are given by  $R = p \cdot Q$ , where price (rate) is  $p$  and plays is  $Q$ , a small change in price will change profits according to  $dR = dp \cdot Q + p \cdot (dQ/dp)$ , where  $(dQ/dp)$  reflects the change in the number of plays as a function of a small change in price (here, royalty rate paid to the label). It is easily seen that when the number of plays,  $Q$ , is very small, a reduction in the rate ( $dp$ ), will not depress revenues by much. Here, the relevant issue is the label’s expectation regarding the change in its volume of plays given a reduction in the rate it accepts from Sirius XM. In this case, the formula can be revised as  $dR = dp \cdot Q + p \cdot E(dq/dp)$ , where  $E$  denotes the expected change in quantity of plays given the new rate.

an increase in plays might warrant accepting a lower rate, given a reasonable expectation that total royalty revenue will increase. But a major label such as UMG reasonably would not expect significant increase in plays, as it would require Sirius XM programmers to deviate substantially from extant playlists that presumably were configured so as to maximize the appeal of Sirius XM's music content to its subscribers (actual and potential). Without the possibility of sufficiently large increases in plays, the major label will be, therefore, disinclined to offer a reduction in the royalty rate that would be profitable to a miniscule label.

43. Moreover, significantly increasing or decreasing the number of plays of sound recordings controlled by a major label would require a major change in Sirius XM's playlists, and such a change is highly unlikely. Sirius XM's demand for music content is derived from its subscribers' (actual and potential) demand for music content. What this means is that Sirius XM has potent economic incentives to curate its music programming, both in terms of the number of music channels and the music played on those channels, in a way that maximizes the aggregate consumer appeal of the Sirius XM subscription service. Sirius XM certainly recognizes this: Sirius XM witness Steven Blatter testified that when Sirius XM creates its playlists, the "merits of the artist and song" trump price. 6/8/12 Tr. 981:14-982:12 (Blatter). The extent to which differences in per-song royalty rates can influence the configuration of station playlists is limited by the degree to which departures from the "optimal" (*i.e.*, profit-maximizing) selection of music increase the risk that Sirius XM will lose subscribers (or not gain as many new subscribers as it otherwise might) and may be compelled to charge lower subscription rates to compensate for the deterioration in the quality of its programming. In other words, the expectation of increased airplay that perhaps encouraged some smaller independents to sign direct deals with Sirius XM likely would not influence materially the decision-making of larger labels for which such an expectation would be substantially less plausible.

44. While Dr. Noll concedes that small independent record labels have different incentives and places less weight on the royalty rate compared to large independents and the majors, he makes no attempt whatsoever to address this issue in his analysis. Plainly, however, his reliance on direct licenses with small independent labels is substantially undermined by his own admission that larger record companies have different incentives and “really care about the rate.” 6/6/12 Tr. 364:9-11 (Noll).

45. Finally, the third factor discussed by Dr. Noll concerns his contention that certain labels with direct deals may have been willing to reach agreement with Sirius XM due in part to dissatisfaction with SoundExchange’s processes for collecting and distributing royalties.<sup>34</sup> I have not examined the merit of this assertion, but insofar as it is accurate, it provides another reason why the rates in the direct deals do not represent a reasonable benchmark rate for the overall marketplace.

*Specific features of Sirius XM’s direct licenses cast further doubt on their utility as a benchmark in this proceeding.*

46. Certain features of the direct license deals likely exerted a downward influence on the rates the participating labels were willing to accept, providing yet another reason why these direct licenses are not a proper benchmark in this proceeding. One such feature is the payment of advances by Sirius XM to certain of these labels, which has the effect of providing an immediate flow of revenues to the label. While such advances are recoupable against future royalty payment obligations, they nevertheless offer the label an increased level of certainty with respect to the royalty revenues it will receive over the life of the contract.<sup>35</sup> And while I have not had occasion to study the finances of the companies that accepted

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<sup>34</sup> Noll Deposition Tr. 117:5-118:3.

<sup>35</sup> See Eisenberg Report at ¶¶ 46-47.

the direct licenses (and in some cases received advances), the opportunity to obtain immediately the full payment of a revenue stream that might otherwise trickle in over several years could very likely be highly attractive to many record labels.

47. A second feature of the direct licenses relates to the fact that labels collect 100% of the royalties owed by Sirius XM. In contrast, it is my understanding that SoundExchange is required by statute to distribute collected performance royalties as follows: 50% to the record label, 45% to the featured artist, and 5% to the secondary artist(s). For a record company that is permitted by its artist contracts to do so, it can take advantage of the fact that it is receiving 100% of the royalties from Sirius XM to more quickly (and perhaps in some instances more completely<sup>36</sup>) recoup any advances paid to its signed artists than would be possible under the statutory scheme.

48. Similarly, for record companies that do not owe royalties because they pay a flat fee to the artists for a work-for-hire, the benefits of receiving 100% of the royalties through a direct license with Sirius XM are even greater. In effect, the benefit of the royalty payment under the direct license for such labels is double what the same royalty rate would generate for the record label under the statutory license.<sup>37</sup> I have not studied the businesses of the record labels that signed direct licenses to determine the terms of their contracts with their artists, and I understand that SoundExchange is submitting testimony by Mark Eisenberg which will further elaborate on this topic, but the existence of a potential strong

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<sup>36</sup> Dr. Noll agrees on this point. "Q: So in a situation where the record company is getting 100 percent of the royalties, as opposed to 50 percent under the statutory scheme, its chances of fully recouping its advances are improved, right? A: That's exactly right." 6/6/12 Tr. 345:5-10 (Noll).

<sup>37</sup> Again, Dr. Noll agrees. "Q: But for a record company that doesn't owe a royalty to its artists because its got -- its doing works for hire, for example, a 7 percent rate from Sirius XM is really equivalent to a 14 percent statutory rate for that -- for that label, right? A: That would be the case, that's right. That's an incentive for them to sign this, exactly." 6/6/12 Tr. 347:7-14 (Noll).

incentive to sign a direct license in order to avoid the apportionment of royalties mandated for statutory rates casts further doubt on the validity of direct licenses as a benchmark.

49. In sum, the direct licenses between Sirius XM and certain independent labels are not an appropriate benchmark for setting the rate in this proceeding. I will not reiterate here the various reasons why this is the case, except to emphasize again what I consider to be their most significant drawback. Briefly stated, they comprise a highly unrepresentative sample – only a small fraction of labels approached by Sirius XM, collectively accounting for roughly 2% of the historical airplay on the service, ultimately agreed to a royalty rate of 5% to 7%. Thus, as a threshold matter, Dr. Noll must explain why this range of rates nevertheless should apply to all remaining record labels, including hundreds that specifically rejected these very same rates. Dr. Noll opines that the framework governing the CRB proceeding tilts in SoundExchange's favor, and record labels for the most part are therefore disinclined to sign direct deals and thereby surrender the fruits of SoundExchange's supposed grip on the regulatory process. Because this key assertion of Dr. Noll is unfounded, his proposed use of the direct deals as a benchmark is inconsistent with sound economics.

#### **IV. Dr. Noll's Second Benchmark: Non-Interactive Subscription Services**

##### **A. Introduction**

50. Dr. Noll's second benchmark is derived from non-interactive subscription services, and more specifically from rates negotiated between one service, Last.fm, and each of the four major record labels. The Last.fm agreements utilized by Dr. Noll do not represent a sound benchmark for purposes of determining a rate schedule for Sirius XM in this proceeding.

51. In the remainder of this section, I discuss and critique, in order, the five steps implemented by Dr. Noll in his second benchmark approach.

**B. Step One: Identify Appropriate Benchmark Services**

52. Dr. Noll's initial step is to identify the category of digital music services most comparable to satellite radio. His determination is guided by the differences in interactivity across services, and more specifically by the proposition that the most comparable type of service should correspond as closely as possible to satellite radio's lack of interactivity. Using this metric, he selects "the least customized Internet services, which includes [sic] simulcasts of terrestrial radio, webcasters, and streaming Internet services."<sup>38</sup> Dr. Noll then narrows his set of possible benchmarks to subscription-based (paid) offerings such as those available from Pandora, Slacker, Last.fm, and Live365.

53. Dr. Noll's conclusion is flawed in a couple of important respects. First, non-interactive subscription services fall under the purview of the CRB and the operative regulatory regime. Dr. Noll states that he would not regard the webcasting royalty rates set by this Court in *Webcasting III* as a valid benchmark in this case because "they were determined by a regulatory process. They didn't meet the willing buyer/willing seller test." 6/6/12 Tr. 386:12-19 (Noll); *see also* 6/6/12 Tr. 387:9-388:8 (Noll) ("[T]he regulated rate is not a market-determined rate, so using it as a market-determined benchmark would be inappropriate."). Yet his use of the Last.fm agreements very much suffers from the same problem. The observed rates, even if negotiated between a single service and a single record label rather than set by this Court, are influenced by the parties' expectations regarding rates that would be set through the regulatory process. In fact, as Dr. Noll recites in his written testimony, some of the per-play rates in the Last.fm agreements are actually expressed as a stated amount or percentage over the existing statutory rate.<sup>39</sup> Given Dr. Noll's statement that regulated rates do

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<sup>38</sup> Noll Report at p. 69.

<sup>39</sup> Noll Report at pp. 78-79.



not meet the willing buyer/willing seller test, his decision to use negotiated agreements so closely tied to the regulated rate is puzzling.

54. Second, the fundamental assumption guiding Dr. Noll's selection of his candidate service type is that Sirius XM's non-interactivity trumps all other possibly relevant factors in determining the appropriate royalty rate. A straightforward comparison of retail prices demonstrates that Dr. Noll's assumption is unwarranted. Non-interactive subscription services like Last.fm and Pandora are priced at three dollars per-month. By comparison, using Sirius XM's current retail prices, a reasonable price estimate for a hypothetical music-only Sirius XM service is \$8.66.<sup>40</sup> Clearly, the Sirius XM service offers features and attributes that lead consumers to value it at substantially greater levels *vis-à-vis* non-interactive subscription services. In fact, the estimated price of \$8.66 is relatively close to the \$9.99 monthly retail price observed across interactive subscription services, which strongly supports the use of interactive subscription services as the appropriate benchmark for determination of rates in this proceeding.

55. Fundamentally, it seems to be Dr. Noll's view that non-interactive internet radio is an excellent substitute for and entirely comparable to satellite radio in the consumers' eyes, because they are both non-interactive. Yet satellite radio is a service that apparently is valued by most subscribers because of its ubiquitous availability in the car, and Sirius XM witnesses have agreed that internet radio services like Pandora are "not available in an easy-to-use way in the car yet." 6/6/12 Tr. 555:20-22 (Meyer). Perhaps that situation will change at some point in the upcoming rate term, and perhaps not – I do not opine on the probability of technological change and its pace. But given the concession by Sirius XM

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<sup>40</sup> With music content estimated to represent one-half of the total value of Sirius XM service, the price of a hypothetical music-only service is one-half the current monthly price of Select packages (\$14.49) plus the music royalty fee (\$1.42).

witnesses that internet radio is not yet widely available in a car in the same easy-to-use way that Sirius XM offers, Dr. Noll erred in focusing solely on the presence or absence of interactivity to the exclusion of other factors that currently would seem to increase the value to consumers of the Sirius XM service.

**C. Step Two: Determine Benchmark Royalty Rate**

56. Dr. Noll's second step is to identify royalty rates negotiated in the marketplace between candidate services and record labels. Dr. Noll ultimately chooses agreements negotiated between Last.fm and the four major record labels because Last.fm, as the least customizable (interactive) of the available benchmark services, is purportedly most comparable to satellite radio.<sup>41</sup>

57. It is immediately apparent that in his second step, Dr. Noll relies on an exceedingly small sample size of rates. The sample consists of four contracts negotiated by a single non-interactive service (Last.fm). As is well understood by statisticians (and economists), the smaller the sample the more difficult it becomes to draw reliable inference for the whole population. Dr. Noll's reliance on the Last.fm agreements is totally inconsistent with sound economics and statistics.

58. The probative value of the Last.fm agreements is also undermined by the fact that two of the four agreements are expired and thus, by definition, do not provide evidence of the rates that even Last.fm could currently negotiate with these labels, and are thus not probative.

59. That the Last.fm agreements are not representative of the royalty rates for non-interactive webcasting generally is confirmed by the public reports regarding Pandora's financials, which indicate that sound recording performance royalties

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<sup>41</sup> Noll Report at p. 76.

paid by Pandora equaled approximately 50% of its 2011 revenues,<sup>42</sup> and more than 60% of its revenues in the first quarter of 2012.<sup>43</sup> These figures would translate to royalty rates of 25% to 30% of gross revenues for Sirius XM, based on the analysis in my written direct testimony that determined one-half of Sirius XM's overall value properly is attributable to music content. While Dr. Noll laments the fact that the royalties rates for Pandora are non-precedential and may not be used in a rate-setting procedure, he certainly was aware of the fact that Pandora pays roughly 50% of its revenues in royalties to the record labels, because he cited Pandora's SEC Form 10Q for the quarter ended July 31, 2011 in his written testimony.<sup>44</sup> While the Pandora rates are not available as precedent, the publicly available information about Pandora should have alerted Dr. Noll to the fact that the Last.fm agreements are far from representative.

60. Dr. Noll's reliance on the Last.fm agreements is problematic for the additional reason that it carries with it the need to account for the per-play component of the mechanism used to determine Last.fm's royalty payments. More specifically, and as Dr. Noll acknowledges, Last.fm's royalty payments are calculated as the greater of the amounts yielded from application of three separate metrics – percentage of revenues, per-subscriber, and per-play. However, because he does not have per-play data for Last.fm, Dr. Noll utilizes analogous information for Slacker, another non-interactive service, to estimate Last.fm's royalty payments under application of the per-play rates found in the Last.fm agreements.

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<sup>42</sup> "Clear Channel and Taylor Swift's Label Agree to Reinvent Royalty System," *New York Times*, June 5, 2012.

<sup>43</sup> "Digital Notes: Pandora's Revenues Grow, and Streaming Music's Global Drive," *New York Times*, May 24, 2012.

<sup>44</sup> Noll Report at p. 66 n. 64. The Form 10Q cited by Dr. Noll states at page 37: "For our fiscal year ended January 31, 2011 we incurred SoundExchange content related acquisition costs representing 45% of our total revenue for that period."

61. Two observations bear mention. First, Dr. Noll's non-interactive services benchmark in general, and his reliance on the Last.fm agreements in particular, needs to account for intensity of usage. Dr. Noll bemoans the supposed paucity of listenership data, but proceeds nevertheless to implement the required adjustments using a single month of data for Slacker as reported to a single record label. Suffice it to say that reliance on a single data point for intensity of usage further exacerbates the initial problem of using four contracts from a single service to derive the appropriate rate for Sirius XM. Furthermore, the need to account for intensity of usage in order to obtain the "percent-of-revenue" rate adds another step in translating observed contractual payment terms into equivalent terms applicable to Sirius XM.

62. Second, the Slacker data relied on by Dr. Noll do not represent the only source of information which could be used to estimate intensity of usage among subscribers to non-interactive streaming services. According to fiscal year 2012 (Feb 2011 – Jan 2012) data reported by Pandora to SoundExchange, Pandora subscribers (*i.e.*, the paying audience) listened to [ ] plays (performances). While Pandora does not report subscriber counts for its paid service, an estimate can be generated by dividing the service's reported subscription revenues by the annual retail price of \$36. For fiscal year 2012, Pandora reported subscription revenues of \$34,383,000,<sup>45</sup> which when divided by \$36 yields a subscriber count estimate of 955,083, and a corresponding monthly

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<sup>45</sup> Pandora Media, Inc. 10-K for fiscal year ending January 31, 2012, at p. 40. Note that Pandora reports as a single entry "subscription and other revenues." The company's 10-K contains no indication of the significance of "other" revenues. However, my assumption that the reported revenues flow entirely from subscriptions has an upward effect on the subscriber count estimate, and thus a downward effect on the per-subscriber monthly performances estimate, *i.e.*, the assumption is conservative insofar as it pushes downward the estimated rate for Sirius XM.

per-subscriber performance figure of [REDACTED].<sup>46</sup> This figure is consistent with Dr. Noll's own estimate of monthly per-subscriber performances on Pandora.<sup>46a</sup>

63. This figure dwarfs substantially the [REDACTED] monthly plays per-subscriber estimated by Dr. Noll from Slacker's royalty payment data, which he uses to estimate percentage of revenue royalty rates of between 25% and 27.5% that are then adjusted to determine a rate purportedly applicable to Sirius XM in steps three to five of his second benchmark approach. Not surprisingly, if Dr. Noll had used the monthly per-subscriber performances figure of [REDACTED] estimated for Pandora, his results would have been markedly different.<sup>47</sup> In the table below, I present a revised version of Dr. Noll's calculations based on estimated monthly plays per-Pandora subscriber.

Last.fm Agmt with (a)	Per-play rate (b)	Per-sub royalty pmt under per-play rate (c) = (b)*1086	Per-sub royalty pmt as % of per-sub revenue (\$3.00) (d) = (c)/\$3.00
Warner	\$0.001	[REDACTED]	[REDACTED]
EMI	[REDACTED]	[REDACTED]	[REDACTED]
Sony	\$0.00165	[REDACTED]	[REDACTED]
Universal	[REDACTED] <sup>48</sup>	[REDACTED]	[REDACTED]

<sup>46</sup> [REDACTED]

<sup>46a</sup> Deposition of Roger Noll, July 24, 2012, at pp. 46-47.

<sup>47</sup> To be clear, it is not my testimony that the Pandora data generate the correct estimate of intensity of usage. Rather, I discuss the Pandora data, and other sources of information, to highlight the substantial variance across intensity of usage estimates, and hence the material imprecision that Dr. Noll's non-interactive services benchmark inevitably introduces. Additionally, I present several intensity of usage estimates to highlight the fact that Dr. Noll's analysis relies on a single data point, to the exclusion of other available information that generates substantially different results.

<sup>48</sup> Dr. Noll's calculations of the per-play rates for Universal and Sony appear to be incorrect. In both cases, the per-play rates are stated with reference to [REDACTED]. Dr. Noll uses [REDACTED] to perform his calculations. Noll Report pages 78-79.

Based on my estimate that music content accounts for one-half of Sirius XM's overall value to subscribers, the figures in the right-hand column imply a percentage-of-revenue rate for Sirius XM of between [redacted], i.e., 50% of the values reported in the right-hand column.<sup>49</sup>

64. There is also information pertaining to intensity of usage for Sirius XM. In *SDARS I*, Dr. Pelcovits used survey data produced by Sirius and XM to derive an estimate of weekly time spent listening to music of 14 hours and 45 minutes per-subscription.<sup>50</sup> Assuming that the average month has 30 days, this translates into 63.21 hours per-month of music listening per-Sirius XM subscription. Finally, adopting Dr. Pelcovits' assumption that 15.5 songs are played on average over the course of one hour,<sup>51</sup> the number of monthly plays per-Sirius XM subscription equals approximately 980. As with the Pandora listenership estimates presented above, this estimate varies substantially from Dr. Noll's Slacker-based single data point of [redacted].

65. Again, the point of this discussion is not to claim that my estimates of intensity of usage are correct and Dr. Noll's estimate is wrong, although his estimate is out of line with other estimates, but rather to highlight the wide range of values one obtains depending on the underlying information source.<sup>51a</sup> Given the substantial variance across estimates, there is no basis for Dr. Noll to advance a benchmark rate that relies on a single point estimate of usage intensity.

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<sup>49</sup> Pandora's payment of roughly 50% of revenues to SoundExchange in Pandora's fiscal year 2012 falls within the range reported in the table's right-hand column.

<sup>50</sup> Written Rebuttal Testimony of Michael Pelcovits at 16, Appendix A, July 2007, Docket No. 2006-1 CRB DSTRA.

<sup>51</sup> Id.

<sup>51a</sup> Dr. Noll acknowledged at his deposition that royalty payments as a percent of revenues vary "all over the map" for non-interactive streaming services due to substantial variation in monthly per-subscriber performances across services. (Deposition of Roger Noll, July 24, 2012, at p. 46.)

**D. Step Three: Portion of Satellite Radio's Value Accounted for by Music Content**

66. Dr. Noll's third step seeks to adjust the percentage of revenue rates obtained from step two (25% to 27.5%) such that they are limited to the music content component of Sirius XM's service.<sup>52</sup> To that end, Dr. Noll applies three separate methodologies, all of which are based on the view that consumers' willingness to pay for Sirius XM, as reflected in retail prices, is a function of the value of each product in the Sirius XM bundle, namely access to music content, access to non-music content, and the Sirius XM transmission network.<sup>53</sup>

67. As a threshold matter, all of Dr. Noll's methodologies are flawed inasmuch as they are based on the proposition that Sirius XM's network and delivery system should be treated as part of the "bundle" purchased by subscribers, *i.e.*, the network and delivery system should be carved out from content as part of estimating the portion of the service's overall value accounted for by music. To begin with, there should be no dispute that without access to music (and non-music) content, Sirius XM's delivery infrastructure would be valued by consumers at zero.

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<sup>52</sup> One notable feature about the "marketplace" agreements with Last.fm upon which Dr. Noll relies is that all of the agreements grant Last.fm the rights necessary to operate its service using all of the authorized sound recordings of the labels. In other words, the royalty rate that is set forth in those agreements is applied to all of Last.fm's revenue as defined in the agreement and all of the performances of a given label's recordings are taken into account in determining compensation to the label, with no distinction based on when a sound recording was made. Dr. Noll does not adjust his SDARS royalty derived from the Last.fm agreements to account for the lack of federal copyright protection for sound recordings fixed prior to 1972 (so-called "pre-72 recordings"). Nor did I make an adjustment in my recommended rate derived from the interactive services. If one were to assume that Last.fm and the interactive services are not required to pay any royalties on the pre-72 recordings they use (a question on which I express no opinion), the payments they make for their use of other sound recordings would have to be viewed as correspondingly higher.

<sup>53</sup> Noll Report at p. 80.

68. In addition, Sirius XM's pricing casts serious doubt on Dr. Noll's contention. The company charges the same \$14.49 per-month price for its Sirius Select and SiriusXM Internet Radio packages, which are substantially similar offerings in terms of content and differ most materially in that one is delivered *via* its satellite network and the other is delivered over the Internet.<sup>54</sup> Such pricing would seem irrational if the company believed that transmission over its satellite network added additional value to its service over and above the content itself. Indeed, Sirius XM's CFO, Mr. David Frear, testified that the company's offerings are priced identically because the company's business is selling content and it does not believe that consumers care about the specific platform over which the content is distributed.<sup>54a</sup> Similarly, Mr. Frear testified that Sirius XM intends to maintain identical pricing for its satellite and Internet offerings as it rolls out in-vehicle receivers capable of receiving the company's programming over either platform. That is, irrespective of the platform over which a consumer elects to receive Sirius XM programming, the monthly subscription price will be the same.<sup>54b</sup>

69. Moreover, there is no evidence that a service provider's investments in transmission and delivery are effectively deducted from subscription revenues prior to calculating royalty payments owed to copyright-holders. For example, the cost of servers and the Music Genome Project are not netted out from Pandora's royalty payments. Rather, the value of a service provider's investments in its delivery mode is reflected – to the extent permitted by consumers' willingness to subscribe to the service, given the alternatives – in the price it is able to charge, and thus in the royalty payments earned by copyright-holders and

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<sup>54</sup> <http://www.siriusxm.com/ourmostpopularpackages-sirius>.

<sup>54a</sup> Deposition of David Frear, August 7, 2012, at pp. 30-31.

<sup>54b</sup> *Id.* at pp. 130-131.



the revenues received by the service provider. Investments that provide greater value (as reflected in price and consumer demand) generate higher royalty payments in an absolute sense, but there is no economic basis for adjusting downward royalty payments as a percentage of revenue to account for greater investments in the transmission network. Again, insofar as those investments translate into greater consumer value, both the service provider and the copyright-holders will earn greater overall revenues.<sup>55</sup>

70. To buttress his assertion that marketplace royalty rates for sound recording performance rights reflect the value of the service provider's delivery system, Dr. Noll points to the fact that the wireless carrier Cricket has agreements for its interactive music service with all the four major labels that includes [REDACTED] [REDACTED].<sup>56</sup> Dr. Noll's use of Cricket as an analogy for Sirius XM misses the mark. He claims that Cricket's [REDACTED] rate reflects adjustments "to take into account other components of the bundle, including transmission service."<sup>57</sup> In fact, Cricket bundles music with a variety of other services unrelated to the delivery of content, including the services common to wireless telephone plans such as voice calling, text messaging and data usage, all of which have independent value for consumers. Because various elements of

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<sup>55</sup> To illustrate, consider the following example involving two music distribution services, Service A and Service B. Service A's investments in a delivery system are relatively modest, while Service B's analogous investments are relatively large. Service A pays 50% of its revenues for access to sound recording rights. Under Dr. Noll's approach, Service B should pay substantially less than 50% of revenue due to the greater size of its investments, even though in the case of each service, the delivery system has no value without access to music. In effect, Dr. Noll asks copyright-holders to shoulder a portion of Service B's decision how to deliver content to consumers, and the resulting financial obligations. Simply stated, Service B's ability to earn a normal rate of return on its investments should be determined in the marketplace rather than by de-valuing the music content licensed by Service B to the point that assures Service B that it *will* earn the expected market rate of return on its investments.

<sup>56</sup> Noll Report at p. 81.

<sup>57</sup> Id.

the bundle of services are priced out in the marketplace, the total value of the bundled service can, in principle, be apportioned among the components of the bundle.

71. In contrast, the Sirius XM transmission system does not have value to consumers independent of the content it transmits. As stated by Sirius XM's CFO, David Frear: "I don't believe that our customers really care whether they're getting the signal across a satellite or a terrestrial repeater or an Internet connection. What they have come to us for is SiriusXM-branded programming for a specific price. And it's 140 channels of music, talk, news and sports. So they just want to listen to that." 6/7/12 Tr. 666:5-11 (Frear). In the case of Cricket, it makes economic sense that the rate earned by sound recording copyright-holders as a percentage of revenues should be adjusted to reflect the fact that some portion of the price is paid by consumers for other content or services that they value (and which are delivered over the same distribution network as the music content). This downward adjustment reflects the value of music content as part of a bundle of numerous services; it has nothing to do with Cricket's delivery system – it has to do with the fact that the delivery system *delivers* services that also have an independent value to consumers.

72. I now turn to specific critiques of Dr. Noll's three approaches to estimating the portion of Sirius XM's overall value that should be attributed to music. His first approach utilizes the \$3.00 per-month subscription price charged by Last.fm and Pandora.<sup>58</sup> In other words, Dr. Noll concludes that Sirius XM would be able to charge its monthly subscription price, less three dollars, for a service without music content but otherwise identical to its current offering.

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<sup>58</sup> Dr. Noll ignores, without good reason in my opinion, non-interactive webcasting services such as Live365 that charge significantly more than \$3 per month for a subscription. These services and their subscription prices are listed in my Third Corrected and Amended Testimony at page 34.

73. Dr. Noll's contention does not square with Sirius XM's actual pricing. In particular, Sirius XM currently offers a plan that does not include any music channels. This "non-music" plan, known as Sirius/XM News, Talk, & Sports, is priced at \$9.99 per-month. Sirius/XM Select is the company's lowest-priced plan that combines music and non-music content. That plan retails for \$15.91 per-month (\$14.49 base price plus \$1.42 music royalty fee), or nearly six dollars more than the non-music plan. If Dr. Noll were correct that Sirius XM and his benchmark webcasting service were comparable and direct competitive substitutes, one would expect a substantial volume of consumers to forego subscriptions to Sirius/XM Select in favor of subscriptions to the company's non-music plan and a second subscription to a benchmark webcasting service, such as Pandora One.<sup>59</sup> In fact, the company's non-music plan accounts for a minuscule fraction of total subscribers.

74. Similarly, if Sirius XM and webcasting services were direct substitutes, it would seem unlikely that Sirius XM could raise the price of its basic subscription without losing subscribers to internet webcasting services, which have not raised their basic subscription prices. Yet Sirius XM has done just that, and according to Mr. Karmazin, the company has perceived no adverse impact on its subscriber growth.<sup>60</sup>

75. Dr. Noll's second approach relies on the results of a survey designed by Professor Hauser. Based on the survey, Professor Hauser concludes that music content accounts for 25.7% of satellite radio's overall value. In my view,

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<sup>59</sup> Note that even if one were to use Sirius XM's old price of \$12.95 per-month, the implied incremental price for music would still exceed \$3.00 by a substantial margin.

<sup>60</sup> "SIRI - Q1 2012 Sirius Satellite Radio Earnings Conference Call," Thomson Reuters StreetEvents, May 1, 2012, p. 3 (Mel Karmazin stating, in the first earnings call after Sirius XM implemented an increase to its subscription price, "Given the approximately 12% base package price increase we implemented in January, this positive churn result and no dip in conversion certainly exceeded our expectations and is an excellent demonstration of the value consumers place on our service.").

Professor Hauser's survey suffers from a faulty design that has the inexorable downward effect on the estimated value of music content. The reliability of Professor Hauser's survey is undermined by the following serious flaws:

- a. Professor Hauser's results are inconsistent with marketplace realities. His estimated value of music content – \$3.24 – is well below the value of music to *marginal* subscribers – \$5.92 – that is implied by Sirius XM's pricing across its plans. The value of music on average across current subscribers would be even higher.
- b. Professor Hauser determines his estimated value for music content without considering the separate music royalty fee that Sirius XM charges subscribers whose service plan includes more than incidental amounts of music.
- c. It is hard to imagine that consumers would pay any positive price for a satellite radio service without content, and yet Professor Hauser's survey finds otherwise. Taken at face value, his survey suggests that subscribers will pay \$1.97 for ubiquitous station availability, plus \$1.20 for premium sound quality, as well as \$2.46 for the absence of commercials, all without any actual content (*i.e.*, if all they could hear on the radio were white noise).<sup>61</sup>
- d. In a survey design of the type employed by Professor Hauser – where respondents are asked to value individual attributes with reference to a fixed price for the offering overall – the higher the number of features or attributes are included, the lower will be the estimated value of any given attribute. Thus, by including several attributes in addition to music and non-music content, Professor Hauser's survey necessarily pushes downward the estimated value of music (and non-music). Moreover, by carving up non-music content into several separate categories, Professor Hauser further depresses the estimated value of music content.<sup>62</sup>
- e. Professor Hauser contends that his survey included the appropriate set of attributes, based on the fact that the sum of average willingness to

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<sup>61</sup> Corrected Written Direct Testimony of John R. Hauser at Appendix G (SXM Dir. Trial Ex. 24).

<sup>62</sup> See Written Rebuttal Testimony of Dr. Itamar Simonson at 18.

pay across all attributes (\$12.47) is reasonably close to the actual monthly subscription price (\$12.95 at the time of the survey). However, given that respondents were provided information on plan pricing and were asked questions with reference to those prices, it is not surprising that their responses would be affected by those prices. Moreover, it is important to recognize that by posing questions with reference to retail prices, Professor Hauser's survey does not address willingness to pay. Assuming a downward sloping demand curve, the retail price reflects willingness to pay only for the marginal subscriber(s). Average willingness to pay across all subscribers (respondents) must exceed retail price.

76. Dr. Noll's third approach is based on the notion that the value of Sirius XM's network and delivery system can be estimated using the company's underlying costs. Dr. Noll characterizes this approach as an implementation of the third statutory factor, but in reality Dr. Noll is advocating a rate determination framework that allows Sirius XM to recover its costs. Simply stated, there is no economic basis to support a rate determination methodology guided by Sirius XM's ability to earn any particular rate of return on its network and delivery costs, or even Sirius XM's recovery of such costs.<sup>63</sup> This is so for the simple reason that Sirius XM's continued operation and financial performance is driven by its forward-looking ability to fund future expansions and improvements to its transmission network, given its expected revenues and costs, including sound recording licensing fees.<sup>64</sup>

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<sup>63</sup> If Sirius XM cannot fully recover its long-run costs, it will be forced to exit or contract. In no sense does a competitive marketplace ensure that these costs will be covered. At best what can be said is that the surviving firms will be able to recover these costs.

<sup>64</sup> Insofar as the Judges determine that a particular rate will jeopardize Sirius XM's continued operation, they have at their disposal the fourth statutory factor. From the standpoint of competition policy, I interpret the fourth factor as allowing for downward adjustments to a proposed rate when that rate is viewed as likely to have a disruptive impact on the economic viability of an otherwise efficient service that appeals to a material volume of consumers. The fourth factor, in my view, should not be used to guarantee a service a particular rate of return on its investment nor to subsidize a service whose business model has proven ineffective in the marketplace.

77. As should be apparent, Dr. Noll's third approach would yield higher or lower rates depending on changes in Sirius XM's costs, or which costs are deducted from the revenues for purposes of calculating rates. In effect, sound recording copyright-holders are asked to shoulder – if necessary – the burden of increases in Sirius XM's costs, or in the extreme to receive no compensation whatsoever if those costs exceed the company's revenues.<sup>65</sup> This makes no sense as a matter of economics, unless Sirius XM is a public utility operating under rate regulation, which it is not. The value of Sirius XM's service is reflected in its price and the strength of consumer demand. As that value increases (or decreases), copyright-holders will earn greater (or smaller) total revenues, but under the "percentage-of revenue" licensing plans their share of revenues will remain the same. Across all scenarios, access to sound recordings properly is viewed as accounting for the same portion of Sirius XM's total value as reflected in its revenues.

78. Beyond its conceptual shortcomings, Dr. Noll's proposal to carve out Sirius XM's transmission and delivery costs is further undermined by his rather expansive definition of "delivery costs."<sup>66</sup> Included in Dr. Noll's tally of costs are expenditures for marketing and sales, subscriber acquisition, and revenue sharing with OEMs. These costs have nothing to do with the satellite network. Instead, these generally relate to Sirius XM's efforts to acquire customers. I find no basis in economics to support the view that the rate paid by Sirius XM to sound recording copyright-holders should be impacted by how Sirius XM elects to market its service to consumers or how the company chooses to share its revenues

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<sup>65</sup> Alternatively, copyright-holder compensation would increase as Sirius XM became more efficient and its costs declined. This outcome is similarly without economic basis.

<sup>66</sup> Noll Report, Table 3.

on the back-end with automobile OEMs.<sup>67</sup> At most, these costs are relevant only with respect to the possible disruption on Sirius XM's forward looking viability that would result from implementation of the rates proposed by SoundExchange.

#### **E. Steps 4 and 5: Rate Calculations**

79. The final two steps of Dr. Noll's second benchmarking approach involve the calculation of a royalty rate for Sirius XM. As discussed above, the inputs feeding into the calculation are deeply flawed, and consequently, the calculation itself yields a rate that should be rejected.

### **V. Concluding Remark**

80. To conclude, I wish to address briefly a question posed by Judge Roberts during my direct hearing testimony. To paraphrase, Judge Roberts asked about the possible implications of including ad-supported (free) non-interactive streaming services in the interactivity adjustment I presented in my written direct testimony. Recall that the objective of this exercise was to obtain a reasonable estimate of the incremental value consumers assign to interactivity. The most straightforward and defensible way to derive such an estimate is to identify two services available to consumers in the marketplace that are as close to each other as possible in pertinent characteristics other than the presence or absence of interactivity. In my view, a comparison of the retail prices of subscription interactive services and subscription (paid) non-interactive services satisfy this objective – the services differ only with respect to interactivity.

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<sup>67</sup> Dr. Noll agrees that internet music services also have subscriber acquisition costs, but he seems to think that the Sirius XM costs are different simply because they are larger. "Q: Okay. And we can agree, can't we, that webcasters probably also spend money to acquire subscribers? A: Not like this. Q: But they do spend money? A: Well, yes, but its nothing like this. I mean, there's – there's no counterpart like this." 6/6/12 Tr. 438:4-11 (Noll). The idea that a category of costs must be taken into account for one service rather than another, simply because the costs are greater for the first service, has no sound economic basis.

81. To introduce ad-supported non-interactive streaming services would, in my view, needlessly confound the exercise. This is so because interactivity would cease to be the only difference between the two services – the presence or absence of commercials would also need to be accounted for. In other words, the exercise would no longer effectively isolate the incremental value of interactivity, which again is the ultimate objective.



I declare under penalty of perjury that the foregoing is true and correct.

Date: 8/8/2012

Janusz A. Ordovery  
Janusz A. Ordovery

### CERTIFICATE OF SERVICE

I, Garrett Levin, do hereby certify that copies of the foregoing **AMENDED REBUTTAL TESTIMONY OF JANUSZ ORDOVER**. (Public version) were sent via electronic mail and overnight mail on the 9<sup>th</sup> day of August, 2012, to the following:

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